# BROADENING THE AVAILABILITY OF THE FEDERAL REHABILITATION TAX CREDIT FOR THE MAIN STREET BUILDING OWNER

Eric James Kuczarski

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Supervisor
David Hollenberg
Lecturer
Graduate Program in Historic Preservation

John Leith-Tetrault
Reader
John Leith-Tetrault
National Trust for Historic Preservation

fg Matero
Graduate Group Chair
Frank G. Matero
Associate Professor of Architecture

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# Chapter 1 – Introduction

Tax incentives for the rehabilitation of historic structures have been available in the United States since the passage of the Federal Tax Reform Act of 1976. Chapters Two through Four of this thesis examine the evolution of the various federal tax incentives for rehabilitation from their beginnings in 1976 through to the present day. Following a slow start, use of the tax incentives for rehabilitation exploded with the introduction of the Economic Recovery Tax Act of 1981. After experiencing a significant decline in use due to changes introduced under the Tax Reform Act of 1986, use of tax incentives, or more specifically, tax credits for rehabilitation, has steadily increased since the mid 1990's. In addition to describing how the tax incentives for rehabilitation have changed over the years, this thesis provides case studies and examples that help explain in detail how building owners, investors, the preservation community, and the United States economy have all benefited from tax incentives.

Chapter Five broadly characterizes a category of commercial real estate herein labeled as Main Street buildings, and proposes changes to the existing federal rehabilitation tax credit provisions that would increase their use by this group of building owners. The review of the evolution of federal tax incentives for rehabilitation shows that an effective credit is one that can be both easily *earned* and *used*. While rehabilitation and use of rehabilitation tax credits continues strong today, it is becoming increasingly clear that the average Main Street building owner is oftentimes unable to earn and/or use the tax credit

in their rehabilitation project. The three major challenges facing the Main Street building owner today are the inability to utilize the credit once it is earned, the inability to earn the tax credit for incremental building rehabilitation, and an insufficient tax credit amount to make many Main Street rehabilitations economically feasible. The remainder of Chapter 5 proposes and analyzes three specific changes to the existing federal tax credit provisions to increase use of the credits by this group of building owners.

The first proposed change recommends increasing the rehabilitation tax credit from 20% to 40%, applicable strictly to Main Street building owners. Increasing the credit from 20% to 40% would directly boost the construction subsidy, increasing the owner's investment return. In some cases, this increased return on investment will allow a project to generate a return sufficient to justify investment by the Main Street building owner, in turn making the project a reality and supporting the revitalization of Main Street communities across the United States.

Furthermore, increasing the credit from 20% to 40% would allow owners of some of the larger Main Street building owners access to the corporate investment market because the increased tax credits generated by the project would help the project surpass the present $500,000 minimum tax credit equity investment hurdle. Access to the corporate investment market is critical for the Main Street building owner because it guarantees the owner a method of using the credits it earns. Unfortunately, increasing the tax credit to 40% will not help the typical Main Street building owner access the corporate investment

market because the amount of tax credits generated by these projects will still not reach the $500,000 minimum investment threshold demanded by corporate investors today.

Creating a transferable tax credit specifically for Main Street building owners would have a profound impact on use of the rehabilitation tax credit by the average Main Street building owner. As has been demonstrated by the state of Missouri's transferable tax credit, this change, coupled with the separation or elimination of the recapture provision, would significantly increase demand for tax credits from the corporate investment market, in turn spurring greater use of the tax credits by the Main Street building owner who would then be assured they can use their tax credit once it is earned.

Finally, eliminating the adjusted basis hurdle associated with the credit's substantial rehabilitation test will allow a greater number of Main Street building owners access to the benefits of the tax credits, whose incentives will lend encouragement and financial support to the incremental revitalization of Main Street communities across the United States.

# Chapter 2 – 1960 through 1975: Historic Rehabilitation Prior to the Introduction of Federal Tax Incentives

### *Historic Preservation through the 1960's*

Although historic preservation can trace its roots in United States culture to the early 1800's,[1] it was not until the 1960's that the rehabilitation of historic structures became a significant issue. During the Great Depression and World War II, little construction (and demolition) occurred, and therefore there was little need for preservation.[2] However, following World War II, two federal programs, the interstate highway program of the Department of Transportation and the urban renewal program of the Department of Housing and Urban Development (HUD) by the early 1960's had what began to be perceived as a significantly negative impact upon the built environment.[3]

These two well-funded programs destroyed countless historic neighborhoods and structures under the name of progress.[4] It was this indiscriminate destruction and subsequent replacement by bland and unsightly "modern" structures that caused many Americans to call for action to be taken to protect the country's built heritage.[5] In 1966 the United States Congress passed the National Historic Preservation Act (the Act), which among other provisions established the National Register of Historic Places

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[1] William J. Murtagh, *Keeping Time: The History and Theory of Preservation in America,* Rev. ed. (New York: John Wiley & Sons, Inc., 1997), 207.
[2] Alexander Garvin, *The American City: What Works, What Doesn't* (New York: McGraw-Hill, 1996), 405.
[3] Murtagh, *Keeping Time,* 62.
[4] *Ibid.*
[5] Garvin, *The American City,* 405.

(National Register) and the Advisory Council on Historic Preservation (ACHP). The Act, through the newly-established Historic Preservation Fund, also authorized matching grants-in-aid for historic preservation to the states and the National Trust for Historic Preservation.[6]

The National Register was established "to create a list of those sites and properties of the past worth keeping" and included "sites, buildings, objects, districts, and structures significant in American history, architecture, archeology, and culture."[7] The ACHP was created, in part, to provide a way for interested parties to comment on any project, funded (in whole or in part by) or requiring a license from the federal government, that impacts sites or properties on or eligible for the National Register. The ACHP's review process is more commonly know as a Section 106 review, named after the section in the Act where the review requirements are laid out. Then, as now, the ACHP attempts to mediate conflicts of interest between the various parties, while bringing about resolutions that meet both the needs of the preservationists and the federal agency funding or undertaking the project.[8]

Since 1968, more than $1 billion in historic preservation grants-in-aid have been provided through the Historic Preservation Fund to numerous states, territories, Indian tribes, local governments, and the National Trust for Historic Preservation.[9] Funding

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[6] Murtagh, *Keeping Time*, 210.
[7] *Ibid*, 66.
[8] *Ibid*, 68, 73.
[9] "Historic Preservation Fund Stats" (accessed May 28, 2002), http://www2.cr.nps.gov/hpf/hpf_p.htm.

reached slightly higher than $60 million in 1979, dropped to a low of $24 million in 1986,[10] and steadily rebounded to $47 million in 2001.[11] In accordance with established criteria, funding is typically used to 1) identify and survey historically significant resources, 2) prepare comprehensive preservation plans, and 3) preserve (restoration, rehabilitation, and/or stabilization), either directly or indirectly, the identified resources.[12] However, with a 2001 average state appropriation of only $788,000,[13] very little funding has ever been available for "bricks and mortar" projects such as historic rehabilitation projects.

### *Historic Rehabilitation Takes Root in the 1960's and Early 1970's*

While the nation was becoming concerned about the loss of a significant number of historic structures and lobbied Congress for laws designed to protect our heritage, some concerned citizens took grassroots style action and purchased historic buildings directly for rehabilitation and reuse. These buildings generated interest because of their potential to be rehabilitated for a use compatible with the historical significance of the structure. For example, the purchase of the former Ghirardelli chocolate factory in San Francisco by concerned San Franciscans William M. Roth and Mrs. William P. Roth, and its subsequent adaptive reuse into a 175,000 SF specialty retail center at a cost exceeding

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[10] David Listokin, Barbara Listokin, and Michael Lahr, "The Contributions of Historic Preservation to Housing and Economic Development," *Housing Policy Debate* 9, no. 3 (1998): 438.

[11] "Historic Preservation Fund Stats" (accessed May 28, 2002), http://www2.cr.nps.gov/hpf/hpf_p.htm.

[12] Murtagh, *Keeping Time,* 71-72.

[13] "Historic Preservation Fund Stats" (accessed May 28, 2002), http://www2.cr.nps.gov/hpf/hpf_p.htm.

$10 million in 1964,[14] is often quoted as the first successful adaptive reuse project in the country.[15]

Another example of this type of grassroots preservation was the revitalization of the Pioneer Square district in Seattle, Washington in the 1960's and 1970's. During the 1960's a group of entrepreneurs and artists began purchasing vacant buildings in the Skid Road district of Seattle (later to be known as Pioneer Square), and rehabilitated them into rentable condition for a variety of uses, from apartments, to offices, to ground floor retail.[16] The properties were typically purchased with low down payments, and modest amounts of cash were invested, bringing them into rentable condition at relatively low lease rates of $1 to $2 per square foot per year.[17]

In the late 1960's developers and planners proposed demolishing the historic buildings of Pioneer Square, to be replaced with modern office towers.[18] However, activists successfully lobbied the Seattle City Council to establish a national historic district, an effort that culminated in the designation of the area as the Pioneer Square Historic District (NR, 1970).[19] While the public sector created an architectural review board,[20]

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[14] Urban Land Institute, *Adaptive Reuse: Development Economics, Process, and Profiles* (Washington, DC: Urban Land Institute, 1978), 2.
[15] "The History Behind Ghirardelli Square" (accessed March 17, 2002), http://www.ghirardellisq.com/history/history.shtml.
[16] Alan F. Black, "Making Historic Preservation Profitable – If Your Willing to Wait" in *Economic Benefits of Preserving Old Buildings* (Washington, DC: The Preservation Press, 1976), 21.
[17] *Ibid.*
[18] Garvin, *The American City,* 420.
[19] Black, "Making Historic Preservation Profitable," 21.
[20] Designation to the National Register does not result in architectural design standards. Architectural review boards are typically the function of local, not national historic districts.

invested $2.1 million in public improvements, and began strict enforcement of city property maintenance requirements, the private sector responded by rehabilitating more than half of the area's 150 historic structures, causing area employment to jump from 1000 to 6000 and the area's tax base to increase 1000 percent.[21] The adaptive reuse of the Grand Central Hotel in Seattle is a prime example of the grassroots investment that characterized the 1960's and early 1970's.

### *Case Study: The Grand Central Hotel*[22]

In 1971, Alan Black, along with Pioneer Square adaptive reuse veterans Ralph Anderson and Richard White, purchased the vacant, four-story, 66,000 square foot Grand Central Hotel building for $230,000 "because [it was] there."[23] When the city decided to erect a park on the east side of the Hotel property, the owners saw the opportunity to develop an arcade concept, with shops opening up to the central arcade on the first floor, basement shops and office space above. After obtaining a bank loan for $900,000 and contributing equity of $375,000, rehabilitation proceeded in stages. The first floor retail was completed in early 1972, and the first office tenant moved into the fourth floor at the end of 1972. An additional $300,000 in bank loans was obtained to complete the rehabilitation of the second and third floor office space by the summer of 1973. The building was fully rehabilitated and rented just a little more than two years after it was purchased. The developers reported no appreciable return on their investment of

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[21] Garvin, *The American City*, 421.
[22] Case study from Black, "Making Historic Preservation Profitable," 20-27.
[23] *Ibid.*

$375,000 as of 1975, but expected to be able to significantly increase their now-below market rental rates as leases rolled over in the coming years, thereby allowing for a reasonable return on their investment over time. The Grand Central Hotel, now known as the Grand Central Arcade, continues to operate today with 14 retail stores on the first and basement floors, and office space above.[24]

Professional developer and public sector interest in historic preservation followed the early successes of grassroots projects such as those in Seattle. The city of Boston worked with the Rouse Company in the mid 1970's to redevelop Faneuil Hall Marketplace, a historic public market first constructed in 1722 and significantly expanded in 1826.[25] The city made public improvements, rehabilitated the facades, and leased the improvements to Rouse for 99-years,[26] while Rouse was responsible for finding tenants, arranging financing, and managing the project on an ongoing basis.[27] Other such successful rehabilitation projects of the early to mid 1970's include the Trolley Square retail project in Salt Lake City, Utah,[28] and the adaptive reuse of the 80-year-old Cairo Hotel as apartments in Washington, DC.[29]

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[24] "Grand Central Arcade History and Merchants" (accessed May 29, 2002), http://grand-central-arcade.com/html/history/history.html.

[25] John Sower, "Financing and Developing Large Commercial Preservation Projects" in *Economic Benefits of Preserving Old Buildings* (Washington, DC: The Preservation Press, 1976), 137.

[26] Leasing the land and improvements is beneficial to the developer: the developer incurs no land acquisition costs, financing 100% of the land and improvements.

[27] Sower, "Financing and Developing Large Commercial Preservation Projects," 137.

[28] See Wallace A. Wright, Jr., "Trolley Square: A Preservation Adventure in Salt Lake City" in *Economic Benefits of Preserving Old Buildings* (Washington, DC: The Preservation Press, 1976), 69-73.

[29] Sower, "Financing and Developing Large Commercial Preservation Projects," 136.

The successful projects noted above were, however, more the exception than the rule. Although the National Historic Preservation Act had been in existence for almost 10 years by 1975, the Act had proved ineffective in halting the destruction of many privately owned historic structures.[30] The Act was largely ineffective because there were no carrots (e.g., enticements such as tax credits for rehabilitating historic buildings) or sticks (e.g., penalties or other disincentives for treatment contrary to preservation principles) to encourage and ensure accurate rehabilitations. Congress set out in 1976 to slow this destruction by adding incentives to the tax code (the carrot) to encourage historic rehabilitation, incentives that formed the foundation of the tax incentives fundamental to income-producing historic rehabilitation projects today.

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[30] Peter Weiss, "Federal Tax Incentives for Historic Preservation: A New Direction," *The Real Estate Finance Journal* 4, no. 2 (1988): 35.

# Chapter 3 - Federal Tax Incentives for Rehabilitation Through the Early 1990's

Today's federal tax incentives for historic rehabilitation are the culmination of more than 25 years of changes in United States tax laws designed specifically to encourage rehabilitation. The first tax incentives for rehabilitation, enacted under the Federal Tax Reform Act of 1976, proved largely ineffective. The first tax credit was introduced under the Revenue Act of 1978, and the provisions of the credit were significantly improved with the Economic Recovery Tax Act of 1981. Changes introduced with the Tax Reform Act of 1986 significantly curtailed use of rehabilitation tax credits through the early 1990's.

## *The Federal Tax Reform Act of 1976 and Revenue Act of 1978*

No federal tax incentives for rehabilitation projects existed prior to 1976.[31] The need for tax credits for preservation was first expressed at a joint Williamsburg/National Trust conference in 1963, the results of which were published as *Historic Preservation Today.*[32]

The United States Congress enacted the first tax incentives for historic preservation as part of the Federal Tax Reform Act of 1976. The goal of these changes was to correct the

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[31] Department of the Treasury, Internal Revenue Service, *Rehabilitation Tax Credit,* Market Segment Specialization Program Training 3149-109, rev. 02/2002, 1-1.
[32] Murtagh, *Keeping Time,* 74.

economic imbalance favoring new construction over preservation by making the rehabilitation of historic structures as financially attractive to real estate investors as that of new construction.[33] The following four tax code changes were enacted to encourage the rehabilitation of income-producing commercial and residential historic structures in the United States:[34]

1. *5-year Amortization of Rehabilitation Expenditures* – This provision allowed for a 5-year amortization[35] of certified rehabilitation expenditures expended on a certified historic structure.[36] Without this provision, investors would be required to depreciate[37] their rehabilitation expenditures over a 15 to 30 year period,[38] a less attractive alternative to any prudent investor.[39]

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[33] *Ibid.*

[34] The information in this section compiled from Internal Revenue Service, *Rehabilitation Tax Credit,* 1-2; Jared Shlaes and Michael S. Young, *Financing Preservation in the Private Market,* Information Sheet No. 27 (Washington, DC: National Trust for Historic Preservation, 1981), 17-18; Urban Land Institute, *Adaptive Use,* 26-28.

[35] Amortization is a tax concept. Amortization allows a taxpayer to deduct a certain amount (in this case, 1/5 of the total rehabilitation expenditures each year for five years) from their earnings, reducing tax liability.

[36] The National Park Service is responsible for both certifications. Owners of properties on the National Register, either individually or listed as contributing to a national register historic district were eligible to apply for certification. Owners of properties listed as contributing to a certified local district were also eligible to apply for certification. This definition of certified historic structure will be used throughout the remainder of this paper.

[37] Depreciation is a tax concept very similar to amortization. Depreciation also allows a taxpayer to deduct a certain amount from their earnings over a defined period of time. Items that are depreciable are typically defined as tangible (like autos and buildings that are expected to wear out over time) whereas items subject to amortization are typically considered intangible (the points a homeowner pays on a home mortgage are subject to amortization, and are amortized over the life of the loan). It is curious that rehabilitation expenditures were amortized, as one would typically expect rehabilitation expenditures to be categorized as tangible, and therefore depreciated.

[38] Weiss, "Federal Tax Incentives for Historic Preservation," 36.

[39] Under the time value of money theory, the longer an investor has to wait to realize a tax deduction, the less valuable that deduction becomes.

2. *Accelerated Depreciation of Shell and Rehabilitation Expenditures* – As an alternative to the above, real estate investors could elect to utilize an accelerated method of deprecation for both their original shell and rehabilitation expenditures. Like the amortization provision above, this change made investments in historic rehabilitation projects more attractive than prior tax codes because of the potential for greater and earlier tax benefits.[40]
3. *No Accelerated Depreciation for Buildings Constructed on Sites of Former Historic Structures* – This provision prohibited a real estate investor who demolished a certified historic structure and then constructed a new structure in its place from utilizing accelerated deprecation. Without accelerated depreciation, the investor faced the prospect of less or even delayed tax benefits, making the adaptive reuse of the historic structure more financially attractive.
4. *Costs to Demolish a Historic Structure not Depreciable* – This provision disallowed an investor who demolished a certified historic structure from recovering those expenses using depreciation. Faced with the prospect of less tax benefits if the historic structure was demolished and a new building constructed, the investor would find it increasingly attractive to carry out a rehabilitation project of the existing structure. This change, in combination with the accelerated depreciation disallowance, provided a strong incentive to investors to consider rehabilitating the existing historic structure.

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[40] The 5-year amortization and accelerated depreciation benefits were discontinued as of January 1, 1984 (Shlaes, *Financing Preservation,* 18).

The changes in tax laws were enacted to provide a strong incentive to investors to rehabilitate income-producing historic structures. However, it appears there were two challenges that stymied significant rehabilitation activity under the new provisions. The first obstacle concerned the tax code.[41] While the 5-year amortization period was designed to be attractive by reducing tax liability related to rehabilitation, the provision often actually triggered a tax preference when computing the investor's tax liability. As a result of this tax preference, almost everyone but ultra-rich investors actually faced a higher tax liability when they tried to take advantage of the 5-year amortization rules. Secondly, the National Park Service (NPS) and Internal Revenue Service (IRS) experienced difficulties in administering the complex provisions of the Tax Reform Act of 1976, preventing the changes from bringing about much new interest in historic rehabilitation.[42]

While the modifications targeting income-producing properties failed to produce much interest by investors, another change included in the Tax Reform Act of 1976, made available to both income-producing and non-income-producing (e.g., a personal residence) certified historic structures, has helped support the goals of preservationists. This modification allows owners of certified historic structures to realize a tax deduction[43] equal to the amount of the decrease in property value[44] associated with

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[41] Weiss, "Federal Tax Incentives for Historic Preservation," 36.

[42] *Ibid.*

[43] A tax deduction differs from a tax credit in that a deduction reduces the amount of income subject to taxation, while a credit directly reduces the amount of taxes due. Dollar for dollar, a tax credit is more valuable than a tax deduction.

contributing a façade easement to a charitable organization, such as a local or state preservation group. In exchange for the tax deduction, the existing and all future owners agree to maintain the historic integrity of the façade in perpetuity.[45]

In 1978 Congress passed the Revenue Act of 1978, which added an investment tax credit providing for a tax credit up to 10% of certain rehabilitation expenditures.[46] The credit was only available to owners of certain commercial buildings such as factories, offices, and hotels; residential property does not qualify. The tax credit could be used to offset the first $25,000 in tax liability plus 80% (90% in 1982 and subsequent years) of the tax liability that exceeded $25,000. Any structure at least 20 years old qualified for the credit, regardless of whether or not the structure was a certified historic structure. However, rehabilitation of a certified historic structure required NPS certification of rehabilitation expenditures in order to qualify for the credit.

NPS statistics show that 512 tax credit projects were approved in 1978, and estimated certified rehabilitation investment was $140 million.[47] Estimated investment in 1979 more than doubled to $300 million, while the number of tax credit projects increased only 24% to 635. In 1980 the number of projects actually dropped to 614 while total investment continued to increase, up 15% to $346 million. The role of tax credits would

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[44] The IRS has concluded that a façade easement reduces the value of a historic property approximately 10 to 15%. See "Façade Easement Contributions" (accessed June 1, 2002), http://www2.cr.nps.gov/tps/tax/IRSFacade.htm.

[45] Urban Land Institute, *Adaptive Use,* 26-28.

[46] Shlaes, *Financing Preservation,* 18.

[47] Unless otherwise noted, all NPS statistics from Listokin, "The Contributions of Historic Preservation to Housing and Economic Development," 438.

grow significantly though, as the Economic Recovery Tax Act of 1981 would finally place certified rehabilitation as a noted contributor to the overall rehabilitation marketplace.

### *The Economic Recovery Tax Act of 1981*

The United States Congress enacted a 25% rehabilitation tax credit as part of the Economic Recovery Tax Act of 1981 (1981 Act). The 1981 Act provided for a 25% tax credit against all qualified rehabilitation expenses incurred in rehabilitating an income-producing certified historic structure, and also allowed a 15% credit against qualified rehabilitation expenditures for structures at least 30 years old (20 % credit for structures at least 40 years old).[48] The 1981 Act also contained provisions ensuring that investors other than the ultra-rich, including most middle class professionals with significant tax liability, could utilize the rehabilitation tax credit to reduce their tax liability.[49] These two changes, replacing the 5-year amortization and accelerated depreciation incentives with a 25% tax credit, and the opening of the tax credit market to middle class professionals, caused an immediate and massive surge in both rehabilitation tax credit projects and investment. The conversion of a former industrial building in Philadelphia into loft apartments provides an excellent example of how the rehabilitation tax credit was utilized in the mid 1980's.

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[48] *Ibid.*

[49] Weiss, "Federal Tax Incentives for Historic Preservation," 36.

### *Case Study: Philadelphia Loft*[50]

This project involved the rehabilitation of a 240,000 square foot historic industrial building in 1985 into 151 market-rate apartments with an indoor garage. The project was financed with approximately 50% equity from a group of individual investors (who could benefit from the rehabilitation tax credit and tax losses[51]) and 50% debt. Each investor contributed approximately $114,000 over a period of five years and realized $76,000 in tax benefits alone (credits and deductions) over the first five years of the project (an amazing 67% return). Any actual profits from operations or sale only added to this generous return.

The 25% rehabilitation tax credit worked because it finally helped investors realize returns consistent with the level of risk assumed in rehabilitation projects. The tax credit helps enhance returns by subsidizing construction costs, allowing an investor to enjoy the same future cash flows at a lower initial investment. Without the tax credit, returns would be too low for the risk undertaken and investors would move their capital to an investment vehicle where risk and reward were more appropriately balanced.

According to the NPS, the number of tax credit projects more than doubled from 614 in 1980 to greater than 1375 in 1981 (the year the 25% rehabilitation tax credit was first enacted), and more than doubled again to 3214 projects by 1985. Estimated

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[50] *Ibid*, 37-38.

[51] In addition to rehabilitation tax credits, real estate investors could also reduce their tax liability by taking advantage of generous accelerated depreciation rates available in the early 1980's.

rehabilitation investment jumped from $346 million in 1980 to $738 million by 1981, and more than tripled to $2.4 billion by 1985.

While preservationists cheered the significant advances brought about by the 25% rehabilitation tax credit program, Congress, intent on cutting abuses of the 1981 Act by investors and developers[52] and eager to reduce income tax rates but keep tax revenues neutral,[53] enacted the Tax Reform Act of 1986 that would initially have a detrimental impact upon investment in historic structures.

### *The Tax Reform Act of 1986*

The Tax Reform Act of 1986 (TRA 1986) sought to reduce overall tax rates for both individuals and corporations,[54] and was one of the most comprehensive and sweeping tax changes in the history of the United States.[55] In order that the reduced tax rates did not reduce overall tax revenue, Congress eliminated most traditional tax deductions and deferral techniques. One significant change was the introduction of what was called the passive activity loss limitation (PALL). PALL introduced three categories of income: passive income (losses) from a trade or business in which the investor does not materially participate, active income (losses) from a trade or business in which the investor

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[52] Murtagh, *Keeping Time,* 75.
[53] Weiss, "Federal Tax Incentives for Historic Preservation," 38.
[54] Unless otherwise noted, discussion on the Tax Reform Act of 1986 from Weiss, "Federal Tax Incentives for Historic Preservation," 38.
[55] Internal Revenue Service, *Rehabilitation Tax Credit,* 1-2.

materially participates (e.g., their job), and portfolio income (losses) from investments such as stocks and bonds.[56]

In the Philadelphia Loft project described above, individual investors had used passive losses and passive credits to offset active income, thereby lowering their tax liability. The PALL provisions of the 1986 Act disallowed this practice of using losses and credits from passive activities to offset active income,[57] instead requiring that passive losses could only be used to offset passive income. This segregation of income (losses) into separate categories shut off access to what had been a significant source of investment capital for historic rehabilitation projects.

As exhibited in Figure 1 below, significant decreases in annual rehabilitation tax credit investment and the number of approved tax credit projects reflects the loss of this important source of rehabilitation capital. Annual rehabilitation tax credit investment decreased from a high of $2.4 billion in 1985 to $0.9 billion in 1988 (36% of high), and the number of approved tax credit projects decreased from a high of 3,214 in 1984 to 1,092 (34% of high) in 1988.[58]

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[56] William B. Brueggeman and Jeffrey D. Fisher, *Real Estate Finance and Investments,* 10th ed. (Boston: Irwin, McGraw-Hill, 1997), 345.

[57] *Ibid.*

[58] National Park Service, Technical Preservation Services, *Federal Tax Incentives for Rehabilitating Historic Buildings,* DC: n.p., 2001), 2.

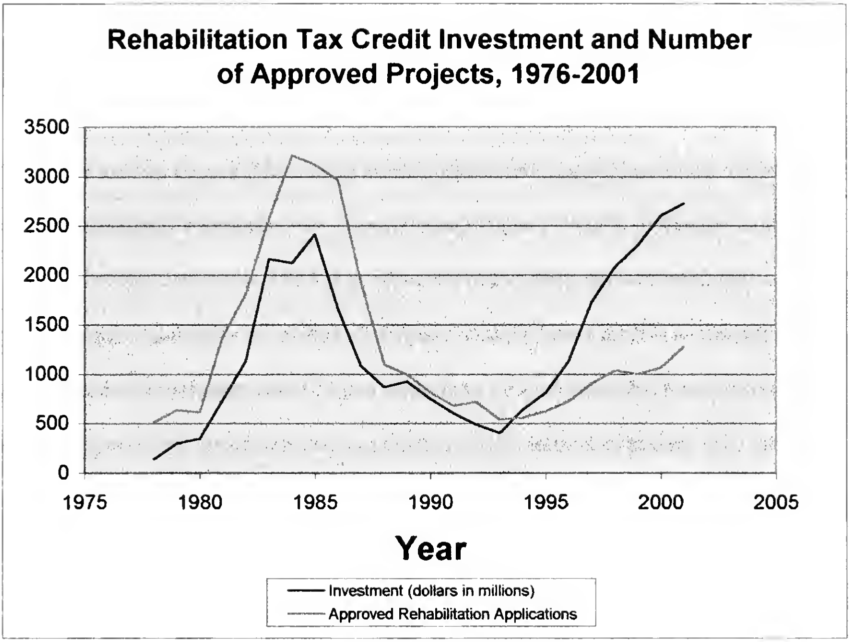

Figure 1[59]

While not as significant as the introduction of PALL, Congress also made changes to the rehabilitation tax credit itself that further contributed to the decrease of interest in using the tax credits. This act reduced the 25% tax credit for rehabilitating an income-producing certified historic structure to 20% and combined the non-historic 15% and 20% credit into a single 10% credit for the rehabilitation of any non-historic building,

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[59] *Ibid.*

further adding the requirement that the structure must have been originally constructed before 1936.[60]

Where the introduction of PALL rules directly eliminated a significant source of potential historic rehabilitation investors, the lower tax credit rates indirectly eliminated a number of other potential investors. The lower tax credit rates effectively increased the owners required equity contribution, causing all projects to show lower returns to investors. This lower return on investment caused some projects to become infeasible because the projected investment return was not consistent with the amount of project risk, and investors simply invested their capital in other projects where the risk-reward ratios were more appropriately balanced.

Annual rehabilitation tax credit investment and the total number of projects continued to decrease during the early 1990's, with the decrease significantly impacted by a generally depressed real estate market in conjunction with the previous changes in tax incentives related to historic rehabilitation. Investment and project numbers bottomed out at $0.5 billion and 524 projects in 1994.[61]

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[60] Internal Revenue Service, *Rehabilitation Tax Credit,* 1-3.

[61] Kaaren Staveteig of Technical Preservation Services of the National Park Service provided the author, via electronic mail on March 11, 2002, with investment and project data since the inception of the rehabilitation tax credit program. Investment and project numbers quoted for years prior to 1991 are based upon data submitted on the Part 2 application, reflecting the developer's *planned* investment. Numbers presented herein for years 1991 and subsequent are based upon data submitted on the Part 3 application, reflecting the developer's *actual* investment.

# Chapter 4 –Tax Incentives for Historic Preservation Today

### *Historic Rehabilitation Recovers from the Tax Reform Act of 1986*

After struggling since the changes of the Tax Reform Act of 1986 and the real estate depression of the early 1990's, use of the rehabilitation tax credit increased in 1995 and has increased significantly since. Today there are essentially four tax credit utilization strategies.

### Matching Passive Losses and Credits with Passive Gains

The most straightforward strategy involves a passive real estate investor who generates sufficient passive income and could therefore benefit from the tax-reducing features of the passive rehabilitation tax credits. Recall that PALL requires that credits or deductions generated by one type of activity (passive or active) may only be used to offset tax liability on the same type of activity.

As an example, a doctor earning $300,000 yearly invests in a number of different partnerships that operate approximately 50 small residential rental properties. The properties generate significant rental income for the partnerships, on which the partners must pay tax each year. One of the doctor's partnerships purchases a historic building that it plans to rehabilitate utilizing the federal credits. Because the doctor is not a real estate professional, the credits passed through to him are considered passive, and can only be used to offset taxes owed on his income from his various partnerships (the

passive income) and not the taxes associated with his earned income as a doctor (the active income).

This strategy is useful only in instances where the various partnerships generate sufficient passive income to directly take advantage of the passive credits. Challenges typically arise from the fact that many new developments do not generate much tax liability in their first few years of operation,[62] and therefore the partnership's portfolio must contain properties that have been operating sufficiently long enough to generate tax liabilities.

### *Material Participation Exceptions to PALL*

The second strategy stems from a modification to the PALL rules enacted under the Omnibus Budget Reconciliation Act of 1993, the next tax change since TRA 1986 to impact the rehabilitation tax credit.[63] This act allows passive credits to be reclassified as active credits for two specific classes of taxpayers: material participation and real estate professionals. By reclassifying the credits as active, the taxpayer is permitted to use the credits to reduce his tax liability from active income.

The material participation classification can be satisfied if a taxpayer "either works more than 500 hours a year or performs substantially all of the work in a business." An

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[62] While a real estate development project may generate *real* income from the beginning, tax deductions often cause the *taxable* income in the early years to go negative, resulting in no taxes due. As income grows in subsequent years, and deductions remain relatively consistent, income eventually outpaces tax deductions, resulting in a positive *taxable* income and a tax bill for the partnership at the end of the year.
[63] This discussion from Internal Revenue Service, *Rehabilitation Tax Credit,* 22-1.

example of the type of taxpayer a material participation classification may assist follows:[64]

> Bill works full-time at his custom millwork shop. He rehabilitated a historic building and moved his shop into the building. Because Bill works more than 500 hours in his business and he has moved his business into the rehabilitated building, the passive rehabilitation tax credits Bill earned will be reclassified as active. This allows Bill to use the credits to offset a portion of his active income.

Material participation rules specifically exempt long-term rental real estate activities:

> Steve spends ¾ of his time as an engineer, and ¼ of his time (approximately 525 hours per year) developing historic properties that he subsequently rents to both commercial and residential tenants. Although Steve meets the hour requirements, he is not entitled to the material participation exception because he is involved in long-term rental real estate activities.

However, material participation rules permit an exemption for short-term rental real estate activities:

> Mary purchases a historic building and rehabilitates it for use as a bed-and-breakfast. Because Mary works more than 500 hours in her business and operates a short-term rental real estate activity, the rehabilitation tax credits Mary earned will be reclassified as active. Mary can then use the credits to offset a portion of her active income.

A taxpayer may also be able to reclassify passive credits as active credits under the real estate professional classification. Requirements for categorization as a real estate professional include spending more than half of a taxpayer's personal services in all business in the real property business. Activities meeting the real property business definition include property development, construction, acquisition, conversion, rental, management, leasing and/or brokering. In addition to the half time requirement, the

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[64] Examples drawn from Internal Revenue Service, *Rehabilitation Tax Credit,* 22-3.

taxpayer must spend at least 750 hours a year in the real property business. If the taxpayer can meet these two tests, the taxpayer can reclassify rehabilitation tax credits as active credits, allowing the taxpayer to reduce taxes owned on active income. In practice, a majority of full time real estate developers, brokers and agents, contractors, architects, and others who spend a significant amount of their time in the real estate profession qualify for the real estate professional exemption.

### *Income Exceptions to PALL*[65]

The third strategy involves two income-based exceptions to PALL: a general exemption and a rehabilitation tax credit only exemption. In the general exemption, taxpayers with adjusted gross incomes (AGI) less than $100,000 are permitted to deduct up to $25,000 in losses from rental property from their AGI, regardless of the source of income. The $25,000 deduction is proportionally reduced for those with AGI between $100,000 to $150,000, and is eliminated for taxpayers with AGI above $150,000.

For taxpayers who invest in historic rehabilitation projects, the $100,000 general exemption limit is increased to $200,000. Also, taxpayers with incomes up to $200,000 are permitted to apply the rehabilitation tax credit to offset taxes owed on up to $25,000 of income, regardless of the source of income. For example, a taxpayer in the 36% tax bracket would be entitled to utilize $9,000 ($25,000 X 0.36) of credits per year. Similar to the general exemption, the rehabilitation tax credit exemption phases out for those with

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[65] Discussion on income exceptions to PALL from "Federal Historic Preservation Tax Incentives" (accessed June 8, 2002), http://www2.cr.nps.gov/tps/tax/brochure2.htm.

AGI between $200,000 and $250,000, and is eliminated altogether for those with AGI above $250,000. The $25,000 starting point for calculating how much of the credit can be used is first reduced by any losses generated by the property.

*PALL and Most Regular Corporations*

The final strategy involves regular corporations, to whom PALL rules typically do not apply.[66] Corporate investment in rehabilitation tax credit projects has become a major source of investment capital in recent years and has contributed significantly to the recent growth in the use of the rehabilitation tax credit. Corporations directly investing in rehabilitation tax credit projects today include Chevron, Transamerica, Wachovia, Bank of America, Sun America, Key Bank, US Bank, Related Capital Company, Lend Lease Real Estate, and Fannie Mae.[67] Chevron is one of the most active investors in rehabilitation tax credits, investing more than $100 million in equity in rehabilitation projects in 2001.[68]

Corporations are typically involved in tax credit investments because it reduces their tax liability, in turn increasing the corporation's earnings, which is a key variable in valuing corporate stocks. Because corporations are focused on increasing earnings, they are typically interested in the tax credits only, and are not looking to participate in the

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[66] PALL rules do not apply to regular C corporations but apply to personal service and closely held corporations in a limited way. See further discussion in Internal Revenue Service, *Rehabilitation Tax Credit*, 22-3.
[67] "Investment Trends and Demand for Historic Tax Credits Described by Speakers at NH&RA Conference" (accessed June 8, 2002), http://www.housingonline.com/hpdc/archive/investment_trends.htm.
[68] "Profiles of Three Leading Investors in Historic Tax Credits" (accessed June 8, 2002), http://www.housingonline.com/hpdc/archive/investor_profile.htm.

anticipated project cash flow or losses. Corporate investments are therefore typically structured to send as much of the tax credit benefits to the investor, while most cash flow and taxable losses from the project are diverted to the developer.

Developers like to partner with corporate investors because the corporation will provide equity to the project at closing and during construction, which will help pay for construction and other development related costs (see explanation of investment process below). If the investor takes the credit himself, the capital will not be available until the investor can claim the credit on his tax return, which in the best case would occur soon after the building is placed in service. As discussed above, TRA 1986 significantly limited an individual's ability to claim the credit, making the option of selling the credit to corporate investors, who can readily make use of the credits, that much more attractive.

Structuring corporate investments in historic rehabilitation is an extremely complex and variable proposition, but some generalizations can be made. Typically, a new limited liability company (LLC) is formed to own the building, composed of the developer and the corporate investor. The corporate investor is often 99.99% owner, and the developer 0.01% owner. As 99.99% owner in the project, the corporation is entitled to 99.99% of the tax credits generated by the project.[69] In exchange for the right to use the tax credits, the corporation contributes equity to the project. Today, the amount of equity is

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[69] The corporation is entitled to take the credit in the tax year in which the building is completed.

approximately $0.88 to $0.93 for every $1 worth of credit. This equity is not contributed to the project all at once, but is paid in over the development cycle. Typically the first 20% is contributed when the LLC agreement is signed, another 60% is contributed when the building is completed and receives Part 3 approval, and the final 20% is paid when the building becomes fully rented and operations stabilize.

IRS regulations require that the developer-corporate investor LLC maintain ownership of the property for a minimum of five years and retain the historic integrity of the property in order to avoid recapture of the credit.[70] Further, IRS hobby loss rules require that the investor demonstrate a profit motive, which is typically satisfied by structuring a deal that generates a 3% cash-on-cash return for the corporate investor during the life of the partnership.[71] All cash flow above this amount and all depreciation benefits are generally diverted to the developer by using a master tenant structure.[72] At the end of the five-year investment period, the developer typically buys out the corporation's interest in the partnership, often at a price equal to 15-20% of the original investment made by the

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[70] IRS regulations require recapture of the credit if the building is sold within five years after it is rehabilitated. The amount recaptured is reduced 20% for each full year of ownership. For example, a sale in the first year would subject the entire credit to recapture, while a sale in year four would subject only 40% of the credit to recapture. This rule applies to all owners, not just corporations.

[71] Cash-on-cash return is the amount of cash returned to the investor on a yearly basis divided by the investor's original investment. For example, an investor invests $1 on January 1st. In order to achieve a 3% cash-on-cash return for the year, the investor would need to receive $0.03 on December 31st ($0.03/$1 = 3%)

[72] Recall that corporations are not necessarily interested in taxable profits or losses. Without the master tenant structure, all profits and losses would have to be split according to LLC ownership percentages – 99.99% for the corporate investor and 0.01% for the developer. The master tenant structure allows the profits and deductions to be diverted to the developer.

corporation.[73] The rehabilitation of five Liggett & Myers tobacco warehouses in Durham, NC, for use as commercial, retail, and loft-style housing is representative of corporate investment in rehabilitation tax credit projects today.

### *Case Study: West Village*[74]

Durham, NC, thrived from the 1880's through the 1970's on the strength of the area's tobacco industries. Downtown Durham declined in the 1970's as fortunes in the tobacco industry began to shift. Liggett & Myers, a leading tobacco powerbroker, had constructed five tobacco warehouses between 1895 and 1926 to support their tobacco operations. These historic structures, located only two blocks from Duke University and minutes from the new Durham Bulls Ballpark, lent themselves to rehabilitation as loft-style apartments.

Blue Devil Ventures, a partnership of former Duke University basketball stars Christian Laettner and Brian Davis, and Duke MBA graduate Tom Niemann, converted the historic warehouses into 238 market-rate loft style apartments plus 31,500 square feet of commercial and retail space. Funding for the $36.6 million project came from a variety of sources. A mortgage of $22.8 million comprised the largest chunk of funding, the developers provided $5.9 million in equity, and two corporate investors were brought into

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[73] Another way to understand how attractive this investment is to a developer is to look at the costs and benefits from the developer's perspective. The developer receives a "loan" during construction, pays 3% interest for five years, and then returns only 15-20% of the capital "borrowed" at the end of five years. While interest rates are low today, 3% interest is still lower and all traditional loans require that all of the capital be paid back.

[74] Community Partners of the National Trust for Historic Preservation, "West Village Case Study," (promotional material, 2001).

the project, providing equity in exchange for the rehabilitation tax credits. Fannie Mae American Communities Fund purchased the federal rehabilitation tax credits in exchange for $5.3 million in equity, and First Union (now Wachovia) contributed $2.6 million in equity in exchange for the state tax credits.

With the recovery of the real estate sector from the depressed real estate market of the early 1990's, and increasing interest in the rehabilitation tax credit by corporate investors, use of the rehabilitation tax credit has increased every year since 1994, when investment and project numbers bottomed out at $0.5 billion and 524 projects.[75] In 2001, a total of 836 projects were completed (a 60% increase over 1994 numbers) and investment reached $1.8 billion, almost four times greater than 1994's total investment.[76]

### *The Impact of the Rehabilitation Tax Credit Program*[77]

The program has had a significant positive impact in cultural, economic, and social fields. Within just the past five years, 2,967 historic buildings have been rehabilitated, many of which were vacant and deteriorating. The program has been utilized to rehabilitate buildings of all types, period, size, and style, from rowhouses in Baltimore, to office towers in Chicago, to Art Deco hotels in Miami. The program is significant not just because of the number of buildings rehabilitated, but also because each rehabilitation design must be certified by the National Park Service as consistent with the historic

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[75] Staveteig, electronic mail.
[76] *Ibid.*
[77] Unless otherwise noted, data in this section from National Park Service, Technical Preservation Services, *Federal Tax Incentives for Rehabilitating Historic Buildings,* (Washington, DC: n.p., 2001), 2-4.

design of the building, ensuring that the rehabilitation's portrayal of the building's history is accurate and consistent with current United States preservation philosophy, while still allowing for continued economic use of the building.

The economic impact of the rehabilitation tax credit has also been significant. The 2,967 historic rehabilitations over the past five years represent a total investment of approximately $4.76 billion, with much of this investment in older urban residential neighborhoods and commercial districts.[78] Economists have estimated that the total national economic benefits of 1997's rehabilitation tax credit investment of $688 million were 23,148 jobs, $762 million in income, $1 billion in gross domestic product (GDP), and $319 million in taxes ($201 million federal, $64 million state, and $54 million local).[79] The economic impact of historic rehabilitation also compares favorably to other types of construction investments. As an example,[80] $1 million spent on nonresidential historic rehabilitation generates, at the national level, 38.3 jobs, $1.3 million in income, $1.7 million in GDP, and $202,000 in state and local taxes. By comparison, $1 million in new nonresidential construction nationally generates 36.1 jobs, $1.2 million in income, $1.6 million in GDP, and $189,000 in state and local taxes.

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[78] In a 1994 survey of NJ historic rehabilitation activity, Listokin and Lahr found that estimated historic rehabilitation as a percentage of total rehabilitation was twice as great in urban and mature suburbs than in developing suburbs. See Listokin, "The Contributions of Historic Preservation to Housing and Economic Development," 442.

[79] Listokin and Lahr used a widely used regional input-output economic model developed by the Regional Science Research Corporation. The model considers direct effects (e.g., labor and materials used in the rehabilitation), indirect effects (i.e., spending on goods and services by industries that produce the items purchased for the rehabilitation), and induced impacts (i.e., expenditures made by the households of workers involved either directly or indirectly in the rehabilitation). For more detail, see Listokin, "The Contributions of Historic Preservation to Housing and Economic Development," 455-456.

[80] Example from Listokin, "The Contributions of Historic Preservation to Housing and Economic Development," 459.

Historic rehabilitation has a greater national economic impact than new construction because of its greater reliance on craftsmanship when compared to new construction. This reliance on craftsmanship means that work that can be done in a factory for new buildings (e.g., new windows) must be performed onsite by laborers in a historic rehabilitation (e.g., repairing, stripping, and repainting the existing windows). Because labor substitutes for capital, and most labor is local, whereas materials can be imported, more money stays in the United States economy and therefore has a greater impact.

Finally, one of the largest social impacts of historic rehabilitation has been the construction of 27,851 units of low and moderate income housing, or 44% of the total number of rehabilitation tax credit assisted housing units completed in the past five years.

# Chapter 5 – Making the Rehabilitation Tax Credit More Accessible to Main Street Building Owners

The review of the rehabilitation tax credit program suggests that a successful tax credit would allow building owners to both easily *earn* and *use* the tax credit. *Earning* the credit requires that the building and its rehabilitation meet both IRS and NPS requirements. A *usable* tax credit is one that once earned, can be utilized immediately by someone with tax liability. Without both of these components, the tax credit is not a useful tool and its effectiveness is diminished. Additionally, the amount of the tax credit can have a significant impact on the project's feasibility; the greater the amount, the more rehabilitations that are possible. This chapter proposes changes to both the earning and use components and the rehabilitation tax credit amount itself, which could make the credit more usable by a greater number of Main Street building owners and help preserve Main Street's sense of place.

## *The Need to Focus Rehabilitation Tax Credit Reform on Main Street Buildings*

Over the past 20 years, the Main Street program of the National Trust for Historic Preservation (the Trust) has supported the grassroots revitalization efforts of over 1,600 historic Main Street communities across the United States.[81] The program uses a four-point approach that places equal importance on design, promotion, organization, and economic restructuring as key components of a successful Main Street revitalization

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[81] "What Happened to America's Main Streets?" (Accessed July 10, 2002), http://www.mainst.org/AboutMainStreet/Decline.htm.

initiative.[82] The Main Street program has developed into a highly successful economic development tool, as evidenced by statistics such as a total of $16.1 billion in total investment (public and private), 56,300 net new businesses, 226,900 net new jobs, and 88,700 building rehabilitations.[83]

What makes the Main Street program unique in the economic development field is its preservation based approach to revitalization. As a preservation-based strategy, the program seeks revitalization partially through the preservation of each community's Main Street buildings. Preserving Main Street buildings helps each community maintain their unique heritage, sense of place, and community.

Unfortunately, the rehabilitation tax credit in its current form makes it extremely difficult for many Main Street building owners to utilize. The three major challenges facing the Main Street building owner today are the inability to utilize the credit once it is earned, the inability to earn the tax credit for incremental building rehabilitation, and an insufficient tax credit amount to make many Main Street rehabilitations economically feasible. Any one of these – let alone all three – poses a significant disincentive to use of the tax credit by the typical Main Street building owner.

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[82] "What is the Main Street Approach to Downtown Revitalization?" (Accessed July 10, 2002), http://www.mainst.org/AboutMainStreet/msapproach.htm.

[83] These statistics are tracked from 1980 to date and reflect activity in over 1,650 communities. See complete statistics at "The 2001 National Reinvestment Statistics" (Accessed July 10, 2002), http://www.mainst.org/AboutMainStreet/numbers.htm.

The use issue is discussed below in two proposed changes: an increase in the tax credit from 20% to 40% for Main Street projects, and the creation of a transferable tax credit targeted towards Main Street buildings. The earning issue is addressed by proposing the elimination of the adjusted basis investment hurdle. The insufficient tax credit amount is discussed as part of the proposed increase in the tax credit from 20% to 40% for Main Street projects. Prior to discussing the proposed changes, size characteristics (square footage) of Main Street buildings are explored. These characteristics will be used later in this paper when discussing the proposed changes.

### *Characteristics of a Main Street Building*

In order to develop some general size characteristics of Main Street buildings, a message was posted on Main Street's listserve[84] to solicit subscribers as to what size (SF, height) buildings they have in their towns. The author received responses from representatives of three Main Street communities and surveyed a fourth Main Street community in Baltimore, MD.

Kennedy Smith, director of Main Street at the Trust, replied that nationwide the average Main Street building has a footprint of 20 ft. x 100 ft. and is two to three stories tall, resulting in an average square footage of 4,000 to 6,000 SF. Ms. Smith stated that the height of the buildings depends both on the size of the community and the region of the country. In general, small Midwest communities tend to have predominantly two story

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[84] The Main Street listserve serves as an informal electronic message board where Main Street members can post and respond to questions related to Main Street revitalization.

buildings, whereas small communities on either coast or in the Rocky Mountain States tend to have a greater occurrence of three story buildings. Regardless of the location of the community, larger communities tend to have a greater percentage of three story plus buildings.

Timothy Bishop, director of the Downtown Walla Walla Foundation, responded to the inquiry by providing detailed information on building square footage and heights for Main Street buildings in the town of Walla Walla, WA, population 30,000.[85] Mr. Bishop provided the following information:

1. 60% of the buildings are approximately 25 ft. x 100 ft., with roughly 75% of these buildings two stories tall for a total square footage of 5,000 SF.
2. 25% of the buildings are approximately 100 ft. x 100 ft. for a 10,000 SF ground floor and the majority of these buildings are three stories for a total square footage of 30,000 SF.
3. The remaining 15% of the buildings are either predominantly one story and less than 2,000 SF (most often infill construction from the 1960's or '70's), or significantly larger buildings such as the Marcus Whitman Hotel, a 12 story, 91 room hotel and conference center.[86]

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[85] "Population of Cities, Towns, and Counties Used for Allocation of Selected State Revenues State of Washington," (accessed June 22, 2002), http://www.ofm.wa.gov/2001pop/pop_2001_final.pdf.

[86] "Marcus Whitman Hotel and Conference Center History," (accessed June 22, 2002), http://www.marcuswhitmanhotel.com/history/index.cfm.

Marlene[87] of the Friends of Main Street in Winsted, CT, states that in her small town (population approximately 13,000 residents) Main Street building sizes range from as small as 900 SF up to 16,000 SF.

Finally, the author surveyed almost two dozen Main Street buildings located within the West Side urban renewal zone in downtown Baltimore, MD, population 650,000.[88] Prior to 1945, the West Side of downtown Baltimore was the region's traditional downtown shopping destination. The area contained large major department stores and a variety of smaller retailers. Like many other cities, retailers fled the downtown after World War II, following the middle and upper classes to the suburbs. The city's economic development arm, Baltimore Development Corporation, has worked for many years to help redevelop the area. While redevelopment of the larger historic buildings has recently or will soon be undertaken by private developers taking advantage of rehabilitation tax credits, most small buildings remain unimproved. These small buildings range in size from 3,000 SF to 30,000 SF, and are typically three stories tall. A majority of the buildings are under 7,500 SF, with only one building at 30,000 SF. One final characteristic of these small buildings is their mixed-use tenancy, with retail on the ground floor, and office and/or residential on the upper floors.

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[87] Last name not provided.

[88] "Profile of General Demographic Characteristics: 2000, Baltimore city, MD," (accessed June 22, 2002). http://www.mdp.state.md.us/msdc/census/cen2000/sf1/sumyprof/sumy_cnty.pdf, 25.

In summary, a majority of Main Street buildings fall within a range of 3,000 SF to 7,500 SF, and are two to three stories in height. Two story buildings on the lower end of the square footage scale are more common in the Midwest, while three story buildings with square footages approaching 7,500 SF are more often found in Main Street communities on both coasts, the Rocky Mountain States, or larger Midwest cities. For purposes of this paper, two to three story buildings ranging in size from 3,000 SF and 7,000 SF will be described as a typical Main Street building. Most communities have buildings both smaller and larger than the typical, with larger Main Street communities having a greater number of buildings in the 10,000 SF plus range.

### *40% Rehabilitation Tax Credit for Main Street Building Owners*

One way to increase the use of the rehabilitation tax credit by Main Street building owners would be to make the credits more attractive by increasing the rehabilitation tax credit from 20% to 40% of the qualified rehabilitation expenditures.

#### *How the 40% Rehabilitation Tax Credit Would Induce Rehabilitation of Main Street Buildings*

Increasing the credit from 20% to 40% for Main Street buildings would effectively increase the construction subsidy, thereby boosting investment returns for some projects to levels that will incentivize investment by property owners. Table 1 below uses a hypothetical Main Street rehabilitation to demonstrate how increasing the tax credit amount would help lower the owner's equity contribution, thereby increasing the return

**How the Federal Tax Credit Percentage Impacts Project Returns**

| | | **20% Rehabilitation Tax Credit** | **30% Rehabilitation Tax Credit** | **40% Rehabilitation Tax Credit** | **Formula** |
|---|---|---|---|---|---|
| a | # of Floors | 3 | 3 | 3 | given |
| b | Building Size (SF) | 4,500 | 4,500 | 4,500 | given |
| | **Development Costs** | | | | |
| c | Building Acquisition | $90,000 | $90,000 | $90,000 | given |
| d | Rehabilitation Cost at $65/SF | $292,500 | $292,500 | $292,500 | $65*b |
| e | *Total Costs* | $382,500 | $382,500 | $382,500 | c+d |
| | **Annual Operating Income** | | | | |
| f | 1st Floor Store Rental @ $10/SF | $15,000 | $15,000 | $15,000 | $10*b/a |
| g | 2nd and 3rd Floor Apartment Rental @ $1/SF/month | $36,000 | $36,000 | $36,000 | $1*12*2*b/a |
| h | Gross Rent | $51,000 | $51,000 | $51,000 | f+g |
| I | Vacancy Allowance (10% of Gross Rent) | $5,100 | $5,100 | $5,100 | 10%*h |
| j | *Net Rent* | $45,900 | $45,900 | $45,900 | h-I |
| | **Annual Operating Expenses** | | | | |
| k | Operating Expenses (25% of Net Rent) | $11,475 | $11,475 | $11,475 | 25%*j |
| l | *Net Operating Income (NOI)* | $34,425 | $34,425 | $34,425 | j-k |
| | **Financing** | | | | |
| m | Value - NOI at 11% Capitalization Rate | $312,955 | $312,955 | $312,955 | l/11% |
| n | Loan-to-Value Ratio | 65% | 65% | 65% | given |
| o | Loan Amount | $203,420 | $203,420 | $203,420 | m*n |
| p | **Federal Rehabilitation Tax Credit** | **$58,500** | **$87,750** | **$117,000** | credit%*d |
| q | **Building Owner Equity** | **$120,580** | **$91,330** | **$62,080** | e-o-p |
| r | Annual Loan Payment (20 years, 8%) | $19,184 | $19,184 | $19,184 | Per amortization schedule |
| s | Annual Cash Flow | $15,241 | $15,241 | $15,241 | l-r |
| t | **Cash on Cash Return** | **13%** | **17%** | **25%** | s/q |

Table 1

on investment to levels likely to induce more private investment than is presently being produced with the 20% rehabilitation tax credit.

### *Hypothetical Main Street Rehabilitation*

The example in Table 1 is of a hypothetical 3-story, 4,500 square foot typical Main Street building. The owner recently purchased the building for $90,000 and plans to perform a complete certified rehabilitation at an average total construction cost of $65/SF or $292,500, bringing total development costs to $382,500.

Based upon the owner's knowledge of the local retail market, he believes that a 1st floor rent of $10/SF/year is achievable, for a gross yearly retail rent of $15,000. The upper floors will be converted to apartments, 1 per floor, at an average rent of $1/SF/month, for a gross yearly apartment rent of $36,000. Total gross rent is therefore $51,000. After allowing for a 10% vacancy, net rent is expected to be $45,900. Operating expenses (insurance, property taxes, utilities, maintenance, property management, etc.) are expected to run about 25% of net rents, yielding a net operating income (NOI) of $34,425.

The amount of the loan was calculated at 65% of the completed building's value, or $203,420. While there is more than one way to determine the estimated value of a

property,[89] the income capitalization approach is a highly reliable and often used method. When an investor purchases an income producing property, it is instructive to think of value as the amount an investor is willing to pay for the right to receive future income from the property. Therefore, an investor is interested in the amount of NOI a property is delivering, or $34,425 for the example here.

The investor than applies a capitalization rate to this NOI to determine the building's value. Capitalization rates are set by market conditions, with a lower capitalization rate signifying a safer investment. For example, two projects may have the same NOI, but two different capitalization rates, and therefore two different values. Assume two properties generate the same NOI of $34,425. One property is a standard design, suburban, garden style apartment complex in a stable, solid neighborhood with a good operating history. Investors would consider this property a relatively safe investment, assigning a capitalization rate of say 8%, for a total value of $430,313. In comparison, a property that generates an identical NOI, but is located in an untested market area, is unconventional in design, and does not have clearly defined development costs (e.g., unidentified environmental contamination issues, etc.) would be viewed by investors as a more risky investment, receiving a higher capitalization rate. At a capitalization rate of 11% (as used in the example here), $34,425 in NOI generates a value of only $312,955, or 27% less than the value generated by the less risky project.

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[89] In addition to the capitalization rate mentioned here, the other common method of establishing value is to use the sales comparison method. The sales comparison method relies on studying recent sales of other similar buildings in order to derive an estimated value for the subject property.

After the owner determines the loan amount, he needs to calculate his annual loan payment in order to determine the free cash flow. A 20-year loan at 8% interest would require an annual payment of approximately $19,184. Subtracting this amount from the $34,425 NOI results in a free cash flow of $15,241.

The last calculation to be made is to determine the owner's required equity investment and cash-on-cash return. The owner's equity investment is determined by subtracting the mortgage and tax credit equity from total development costs. In the 20% rehabilitation tax credit example, the owner's equity is $120,580. The cash-on-cash return, or expected return for the project, is calculated by dividing the property's anticipated cash flow by the owner's equity investment, or 13% for the 20% tax credit example.

The investor compares this return with the expected return from other investments he could make with his equity. Recall that this building's value was calculated at an 11% capitalization rate, meaning that investors view this project as relatively risky. In real estate, investors in risky real estate development typically look for returns of 20%+. Therefore, it is likely that investors will not find a 13% return acceptable given the high perceived risk. An increased tax credit amount for small projects would help trigger more investment by providing for a more balanced risk-to-reward ratio.

As shown in Table 1, increasing the tax credit from 20% to 30% reduces the owner's equity contribution from $120,580 to $91,330, or by 24%. Because the owner is now only contributing $91,330 in equity, and the cash flow remains unchanged at $15,241, the owner's return is boosted to 17%. This return would still likely be viewed as unacceptable by most investors, meaning that a greater tax credit subsidy is necessary. By increasing the subsidy to 40%, the owner's equity contribution is further reduced to just $62,080, or 49% less than the required equity contribution at the 20% tax credit rate. With a $62,080 equity contribution, the investor's expected return is now 25%, a rate that provides for a more appropriate return given the project's risks.

### *A 40% Rehabilitation Tax Credit Would Also Allow Some of the Larger Main Street Projects to Access Corporate Investment Capital*

Chapter 4 discusses how corporate investment in rehabilitation tax credit projects has helped fuel recent increases in use of the tax credit. Unfortunately, corporate investment today has been limited to projects that generate at least $500,000 in tax credit equity, and corporate investors willing to invest in projects that generate less than $2 million in tax credit equity are rare.[90] This lower limit exists because the underwriting costs to make an investment in a Main Street building are about equal to the costs to underwrite an investment in a $25 million project. Because fees are generated based upon investment

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[90] The Bank of America's Historic Tax Credit Fund states that it places "an emphasis on small projects," and that "the fund will consider properties qualifying for as little as $500,000 in equity." According to Darryl Hicks, "most investors now target larger deals generating $2-$3 million in equity," see "Investment Trends and Demand for Historic Tax Credits Described by Speakers at NH&RA Conference," (accessed June 22, 2002), http://www.housingonline.com/hpdc/archive/investment_trends.htm.

size, investors have generally found that it is just not profitable to invest in deals that generate less than $500,000 in tax credit equity.[91]

If a project were solely utilizing the 20% federal rehabilitation tax credit, the project's qualified rehabilitation expenditures would have to total a minimum of $2,500,000 to generate $500,000 in tax credits[92] - far greater than the $382,500 in total development costs for the typical Main Street building used in the above example. Even in a state with significant rehabilitation tax credits, such as Maryland's 20% tax credit, a project would have to cost at least $1,250,000 to deliver $500,000 in tax credits, still three times greater than the development costs in the above example. The existing 20% rehabilitation tax credit is simply not large enough for Main Street building owners to gain access to corporate investment equity.

Access to corporate investment capital is essential because it provides the owner with the ability to *use* the credit. Some Main Street building owners may be able to earn the tax credit, but either PALL rules or a simple lack of tax liability often prevents Main Street business owners from actually being able to use the credits. However, if the Main Street building owner were able to generate enough tax credits (using a tax credit with a higher

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[91] John Leith-Tetrault, "Historic Tax Credits: Expanding Their Use on Main Street," *Main Street News*, no. 186 (May 2002): 3.

[92] $2,500,000 * 0.2 = $500,000. For simplicity, this calculation and the ones to follow assume that investors are willing to purchase projects qualifying for as little as $500,000 in tax credits, not $500,000 in tax credit equity as stated above. Recall from Chapter 4 that the investor contributes approximately $0.88 to $0.93 in tax credit equity for every $1 in tax credits. Therefore, a project generating $500,000 in tax credits will generate $450,000 in tax credit equity at $0.90, below the typical $500,000 tax credit equity investment threshold. At $0.90, a project would have to generate $555,555 in tax credits to generate $500,000 in tax credit equity.

%) to interest a corporate investor, the owner would be able to make his project a reality. This corporate investment capital is that much more important for owners of small Main Street buildings who have fewer sources of financing available to them than professional developers of larger buildings.

Unfortunately, a quick analysis shows that increasing the federal rehabilitation tax credit from 20 to 40% will *not* help the average Main Street building owner access corporate investment equity, not even in states with significant rehabilitation tax credit provisions. For example, a project eligible for a 40% federal and 20% state (e.g., Maryland) rehabilitation tax credit would have to deliver a minimum of $833,333 in qualified rehabilitation expenses in order to generate $500,000 in tax credits. An $833,333 project yields a project of about 12,800 SF,[93] much larger than a typical Main Street building. With a 40% federal rehabilitation tax credit only, a building would have to be about 19,200 SF in order to generate a $500,000 tax credit.

A 40% federal tax credit would, however, help some of the bigger Main Street building owners access corporate investment equity. A building utilizing the current 20% federal rehabilitation tax credit only would have to be about 38,500 SF in order to generate a $500,000 tax credit. This means that most buildings less than approximately 38,500 SF presently do not have access to corporate investment equity, thus limiting their

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[93] Square footage estimated were made as follows: Qualified rehabilitation expenditures (QRE's) estimated at $65/SF. $833,333/$65/SF = 12,800 SF. The reader is cautioned not to use these numbers as absolutes as QRE's will vary greatly from project to project. For example, if QRE's were $100/SF, the building could be 8,300 SF and generate $500,000 in tax credits. This variation in QRE's and SF does not affect the general conclusions drawn from these calculations.

reinvestment potential. Increasing the federal rehabilitation tax credit from 20 to 40% would allow buildings as small as 19,200 SF in size to access corporate equity. Thus, increasing the federal credit from 20 to 40% would open up corporate investment to buildings ranging in size from approximately 19,200 SF to 38,500 SF in size. This change would significantly impact larger Main Street communities that have a great number of buildings within this size range, such as the 25% of buildings in downtown Walla Walla, WA, that are approximately 30,000 SF. This change would also help some smaller Main Street communities that may have one or two buildings within this size range.

The impact upon larger Main Street buildings would be even greater in states with existing rehabilitation tax credit incentives. In Maryland, projects as small as 19,200 SF in size now potentially qualify for corporate investment because of the additional 20% state credit. Increasing the federal credit to 40% would mean that projects as small as 12,800 SF could qualify for corporate investment. It must be noted, however, that even with the increased federal credit and a significant state credit, the average Main Street building owner will still not have access to the corporate investor market.

### *Helping the Typical Main Street Building Owner Access the Corporate Investment Market: Transferable Federal Rehabilitation Tax Credits*

One of the most effective methods for helping the typical Main Street building owner make better use of the rehabilitation tax credit would be to make the credit for Main Street buildings freely transferable. Permitting the credit to be freely transferable would allow Main Street building owners to sell the credit to those that can utilize the credit, including the corporate investment market to which it presently does not have access.

At present, only the building owner is eligible to earn the rehabilitation tax credit. Thus, when a corporate investor wishes to earn rehabilitation tax credits, they must become part owner of the project. As mentioned previously, it is feasible to incur the costs associated with creating these complex partnerships when development costs are in the millions of dollars, but not practical for the development costs of a typical Main Street building. A transferable credit would effectively eliminate the ownership requirement for small projects, allowing the Main Street building owner access to equity from corporate investors without the complexities of partnerships as required today. Missouri's transferable rehabilitation tax credit provides a good example of how a transferable tax credit could potentially assist Main Street building owners.

Missouri first introduced a 25% rehabilitation tax credit for historic buildings effective January 1, 1998.[94] 1998 legislative changes permitted tax credits earned for work performed on or after August 28, 1998 to be sold, transferred, or assigned. Like the existing federal rehabilitation tax credit, the owner of the building earns the tax credit, or Tax Credit Certification. Unlike the federal rehabilitation tax credit, however, the owner is then permitted to sell, transfer, or assign the Tax Credit Certification freely. As was likely hoped for by supporters of the transferable tax credit, a market for the tax credits has developed, facilitated by the Missouri Tax Credit Clearinghouse, an operating division of the US Bank Community Development Corporation.

Prior to the fall of 1998, Mercantile Bank (now US Bank) Community Development Corporation (US Bank CDC) of St. Louis, Missouri, was involved primarily in low-income housing tax credit transactions as a limited partner investor.[95] In September of 1998 the bank received approval from the Comptroller of the Currency[96] to create a new subsidiary called the Missouri Tax Credit Clearinghouse (Clearinghouse), formed partially to allow the community development corporation to purchase and then subsequently resell the state tax credits to buyers with state tax liability.

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[94] Information in this paragraph from "Historic Preservation Tax Credit Program Guidelines," (accessed June 24, 2002), http://www.ded.state.mo.us/communities/communitydevelopment/pdfs/htcguidelines2.pdf, 1.

[95] Unless otherwise noted, information in this paragraph from Comptroller of the Currency to Mercantile Bank, 4 September 1998, "Interpretive Letter #837," (accessed June 25, 2002), http://www.occ.treas.gov/interp/sep98/int837.pdf.

[96] The Comptroller of the Currency is responsible for chartering, regulating, and supervising all national banks. See "About the OCC," (accessed June 25, 2002), http://www.occ.treas.gov/aboutocc.htm.

Zach Boyers, vice president of US Bank CDC, states that as of June 2002 the Clearinghouse has a Missouri rehabilitation tax credit investment backlog of approximately $10 million.[97] This means that within the state of Missouri today, investors are ready and willing to invest $10 million into rehabilitation tax credit projects. Furthermore, since the Missouri rehabilitation tax credit was enacted, US Bank CDC has invested more than $100 million in tax credit equity (both state and federal) in downtown St Louis alone.

In a typical transaction, the Clearinghouse will offer the owner a set price for the Tax Credit Certifications, say $0.80 per $1 of credit. The Clearinghouse can then package a group of certifications and resell them for a higher price, say $0.90 per $1 of credit, to an investor who can use the state tax credits to reduce their Missouri tax liability.

Although the owner receives $0.80 per $1 in credit it sells, the owner must pay taxes on this income. For example, an owner in the 35% tax bracket would have to pay $0.28 ($0.80 * 35%) in tax for every $1 in credit it sells, leaving the owner with $0.52 ($0.80 - $0.28) that can be put into the project as equity. For a project with $382,500 in qualified rehabilitation expenditures, an owner would be able to realize $39,780 in equity, or 10% of the total project costs, to put back into the project.

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[97] Zach Boyers, telephone interview by author, 20 June 2002.

The Missouri tax credit program works because the Clearinghouse acts as a secondary market maker, bringing together buyers and sellers of the state tax credits, and structuring transactions that are beneficial to both owners and investors. The owner finds the program attractive because he is confident that he will be able to obtain equity in exchange for the tax credits. There are no issues about whether the owner will have enough tax liability to use the credit or be prevented from claiming the credit due to PALL tax rules. The buyer finds the program attractive because it can purchase tax credits in quantities that it desires, helping the company boost its earnings through tax credit investment at no risk.

It should be noted that there is one other significant difference between the federal and Missouri tax credit provisions that makes the Missouri transferable tax credit successful. With the federal credit, the owner must retain ownership and retain the historic integrity of the building for five years in order to avoid recapture of the credit. An owner who fails to satisfy these requirements during the five-year holding period must pay back a portion of the credit.[98]

In Missouri, the tax credit has no such recapture provision. Because the Missouri tax credit has no recapture provision, an investor assumes absolutely no risk when it purchases a tax credit the owner has already earned. With no risk, there is no

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[98] IRS regulations require recapture of the credit if the building is sold within five years after it is rehabilitated. The amount recaptured is reduced 20% for each full year of ownership. For example, a sale in the first year would subject the entire credit to recapture, while a sale in year four would subject only 40% of the credit to recapture. This rule applies to all owners, not just corporations.

underwriting cost to purchasing the credits. Because there is no cost, the underwriting cost hurdle that now prevents investment in Main Street projects is effectively eliminated, making it cost effective to purchase a tax credit of any size.

In order for a federal transferable tax credit to be effective for the Main Street building owner, the recapture provision must not be passed on to the purchaser of the tax credits. This can be accomplished either by eliminating the recapture provision altogether as the state of Missouri has done, or by separating the recapture liability from the credits themselves, and having them remain with the building owner. Eliminating the recapture provision altogether would be the simplest, but the protection against inappropriate modifications it presently offers would be eliminated. In the second option, recapture would remain with the owner, allowing for both protection of the building's historic integrity and a risk-free transferable tax credit. The challenge with the second option is that the building owner never claimed the credit in the first place; therefore there is nothing to recapture. This issue could be addressed by assessing a tax penalty equivalent to the amount of the credit that would have been recaptured.

### *Supporting the Incremental Rehabilitation of Main Street Buildings: Modifying the Substantial Rehabilitation Requirement*

The IRS substantial rehabilitation rules state that an owner qualifies for the rehabilitation tax credit only if qualified rehabilitation expenditures exceed the greater of $5,000 or the adjusted basis of their building.[99] The United States Congress enacted these regulations to ensure that owners substantially rehabilitated their property.[100] Unfortunately, a number of Main Street building owners have a high adjusted basis and can only afford to make relatively moderate improvements, meaning they are unable to qualify for the rehabilitation tax credit. Eliminating the adjusted basis hurdle would significantly increase the number of property owners eligible for the credit, thereby spurring greater reinvestment in Main Street communities throughout the United States.

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[99] "IRS Requirements," (accessed June 29, 2002), http://www2.cr.nps.gov/tps/tax/brochure2.htm#IRSRequirements.

[100] Internal Revenue Service, *Rehabilitation Tax Credit,* 6-1.

Adjusted basis is generally defined as the purchase price of the property minus the cost of the land, plus improvements, minus depreciation. An example of how to calculate the adjusted basis follows:

> John purchased a commercial building on Main Street for \$350,000 two years ago. The assessor states that 30% of the value of the property is in the land, and the remaining 70% is in the building, so John allocates \$105,000 to land. John has made no improvements to the building, and has taken two years worth of depreciation, or \$12,564.[101] The adjusted basis is therefore \$350,000 - \$105,000 - \$0 - \$12,564 = \$232,436.

Therefore, John must incur a minimum of \$232,436 in qualified rehabilitation expenditures in order to qualify for the rehabilitation tax credit.

The formula for computing the adjusted basis yields a number of observations. First, an owner who has recently purchased their building, and therefore has taken relatively little depreciation, will have a substantially greater adjusted basis than an owner who purchased an identical building 15 years earlier. For example, if John had purchased the building 15 years ago, he would have claimed \$94,230 in depreciation thus far, setting his substantial rehabilitation hurdle at only \$150,770, or 35% less than in the above example. What this calculation demonstrates is that it is easier for an owner who has owned a building for a longer period of time to qualify for the tax credit, than it is for an owner who recently purchased their building. Furthermore, an owner who makes improvements to their building must add these costs to their basis, raising the substantial rehabilitation hurdle for any future use of the tax credit.

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[101] Per IRS regulations, all commercial buildings are presently depreciated on a straight-line basis over 39 years. Depreciation is only taken against the value of the building, not the land. The value of the building is \$350,000 - \$105,000 = \$245,000. Yearly depreciation is therefore \$245,000/39 = \$6282.

The above discussion is pertinent to the Main Street building owner because oftentimes a Main Street building owner desires to make improvements in small increments, maybe a façade improvement first, then two or three years later a rehabilitation of the first floor space, and finally two years later an adaptive reuse of the upper floors for housing. A Main Street building owner often reinvests in their property as the property generates income. It is much easier for a large-scale developer to meet the substantial rehabilitation test because they can access the large sums of investment capital necessary for substantial rehabilitation.

Furthermore, change in many Main Street communities is incremental and does not occur overnight. Main Street building owners initially respond to an improving community by fixing up their façade and store space to help attract more clients and grow business revenues. If the improvements continue and residential rents rise, the owner recognizes that it would be better for his bottom line to rehabilitate the upper floors as housing than to use it as storage space. Any owner who has recently purchased their building and therefore has a significantly high adjusted basis will find it next to impossible to meet the substantial rehabilitation requirement when planning incremental improvements. Meanwhile, a neighboring business owner with similar plans, who has fully depreciated his building, need only spend $5,000 to meet the substantial rehabilitation test.

Modifying the substantial rehabilitation requirement to require only a minimum expenditure of $5,000 would allow many more Main Street building owners to access the benefits of the rehabilitation tax credits. An owner should not be prohibited from using the credit simply because they recently purchased their building and have a high adjusted basis. This change would also support and further encourage the incremental improvement of Main Street communities, a proven method of Main Street redevelopment.

# Chapter 6 – Conclusion

The rehabilitation of historic structures has come a long way since its grassroots beginnings in the 1960's. After a slow start with the first tax incentives for rehabilitation in 1976, rehabilitation tax credit investment increased significantly because of the incentives introduced with the Economic Recovery Tax Act of 1981. 1986 saw the passage of the Tax Reform Act of 1986, which greatly reduced rehabilitation tax credit investment through the early 1990's, but things began to turn around by the mid 1990's. This turnaround was due mainly to an improved national economy and a growing interest in tax credits by corporate investors.

While rehabilitation and use of tax credits continues strong today, it is becoming increasingly clear that the average Main Street building owner is oftentimes unable to either *earn* and/or *use* the tax credit in their rehabilitation project. The preservation of Main Street buildings is essential in helping each community maintain their unique heritage, sense of place, and community. The three major challenges facing the Main Street building owner today as relates to the federal tax credit are the inability to use the credit once it is earned, the inability to earn the tax credit for incremental building rehabilitation, and an insufficient tax credit amount to make many Main Street rehabilitations economically feasible.

Three specific changes to the existing federal rehabilitation tax credit provisions will help spur greater use of the tax credit by the Main Street building owner. The first recommendation is to increase the credit for Main Street building owners from 20% to 40%. This change will help spur investment in two ways. First, increasing the tax credit percentage will boost the construction subsidy, in turn reducing the owners required equity investment. Because the initial investment amount is lower and the cash flow generated by the property remains the same, the owner's investment return improves, spurring rehabilitation activity.

Secondly, increasing the tax credit from 20% to 40% will help spur rehabilitation in Main Street communities because it will open up the corporate tax credit investment market to owners of larger Main Street buildings who presently do not have access to this market. Unfortunately, the analysis in Chapter 5 shows that the increased credit percentage will not open up the average Main Street building owner to the corporate investment market as the tax credit amount will not meet the minimum thresholds presently set by corporations. However, larger Main Street buildings in the 19,200 SF to 38,500 SF range should be able to access corporate investors that they generally have not had access to thus far. In states with their own rehabilitation tax credits in addition to the federal tax credit, such as Maryland's 20% credit, buildings as small as 12,800 SF could potentially qualify for corporate investment.

The second, and perhaps most effective change to spur rehabilitation of Main Street buildings would be to permit Main Street building owners to freely transfer their tax credits to those that could readily make use of the credits. The state of Missouri permits its tax credits to be freely transferred, which has resulted in a $10 million tax credit investment backlog today – owners cannot rehabilitate buildings fast enough to meet investor's demand for the credit! A transferable tax credit would permit a Main Street building owner to realize approximately $0.52 for every $1 in tax credit after it pays taxes on the income received. In effect, the transferable tax credit would provide the owner with enough equity to cover 10% of their total construction costs. In order for this provision to be truly effective, Congress would have to ensure that the recapture provision was not passed on to the purchaser of the tax credits. This can be accomplished either by eliminating the recapture provision altogether as the state of Missouri has done, or the recapture liability could be separated from the credits themselves and remain with the building owner. Separating or eliminating the recapture provision would effectively reduce investor's risk to zero, a change that would eliminate the existing underwriting cost hurdle that now makes corporate investment in Main Street buildings not cost effective.

Finally, changes to the existing substantial rehabilitation requirement will encourage greater rehabilitation in a manner more consistent with the observed revitalization patterns of today's Main Street communities. Today's substantial rehabilitation requirement allows owners to claim the credit only if they spend the greater of $5,000 or

their adjusted basis. The adjusted basis threshold unfairly penalizes newer building owners with high adjusted basis from utilizing tax credits to make improvements. Furthermore, improvements in Main Street communities are typically made incrementally, not in large, substantial rehabilitations as is often observed for larger rehabilitation projects. By eliminated the adjusted basis threshold, but instead requiring just the $5,000 threshold, more Main Street business owners would be able to qualify for the credit, in turn supporting and encouraging the incremental improvement of Main Street communities across the United States.

# Glossary

The fields of historic preservation and the Internal Revenue Service have each developed a collection of terminology unique to their individual specialties as relates to the federal rehabilitation tax credit. This glossary defines these terms. Definitions have been drawn primarily from the publications of the National Park Service, the Internal Revenue Service, and William J. Murtagh, *Keeping Time: The History and Theory of Preservation in America,* Rev. ed. (New York: John Wiley & Sons, Inc., 1997).

**Adjusted basis** – The value of a property for tax purposes. Adjusted basis can generally be calculated by taking the purchase price, subtracting the cost of land, adding improvements already made, and subtracting depreciation already taken.

**Amortization** –The expensing, for tax purposes, of intangible assets over a period of time.

**Capitalization rate** – The ratio of NOI to property value. The capitalization rate is used to derive a property's value from its NOI.

**Cash-on-cash return** – The expected annual return (expressed as a %) of an owner's equity investment in a property.

**Certified historic structure** - A building that is listed individually in the National Register of Historic Places or a building that is located in a registered historic district and certified by the National Park Service as contributing to the historic significance of that district. A registered historic district may either be a national or local historic district.

**Certified rehabilitation** - A rehabilitation of a certified historic structure that is approved by the National Park Service as being consistent with the historic character of the property and, where applicable, the district in which it is located.

**Depreciation** - The expensing, for tax purposes, of tangible assets over a period of time.

**Equity** – Cash invested by the owner of a property.

**Façade easement** – A partial interest in real property, through donation or purchase, recorded in a deed, protecting the identifying elements of the interior/exterior or space around the property deemed important to be preserved.

**Federal rehabilitation tax credit** - 20% tax credit for the certified rehabilitation of a certified historic structure.

**Income producing property** – Any property that is held for a business purpose (i.e., not a personal residence).

**Main Street building** - Two to three story buildings ranging in size from 3,000 SF and 7,000 SF, located in Main Street communities throughout the United States.

**Main Street communities** – Traditional and often historic downtown commercial areas, typically found in small to mid-sized United States cities.

**Material participation** – A PALL exemption granted when an owner either works more than 500 hours a year or performs substantially all of the work in a business.

**Net operating income (NOI)** – Income generated by the property before debt service payments and income taxes.

**Part 2** – The second of a three-step application process necessary to obtain designation as a certified rehabilitation. In this application the owner documents the existing condition of the building and presents his rehabilitation plans to the National Park Service approval.

**Part 3** - The third of a three-step application process necessary to obtain designation as a certified rehabilitation. In this application the owner documents the finished rehabilitation and requests designation as a certified rehabilitation from the National Park Service.

**Passive activity loss limitations (PALL)** - The passive activity limitation provides that losses and credits from "passive" income sources, such as real estate limited partnerships, cannot be used to offset tax liability from "active" sources such as salaries.

**Qualified rehabilitation expenditures** - Costs associated with the work undertaken on the historic building, as well as architectural and engineering fees, site survey fees, legal expenses, development fees, and other construction-related costs, if such costs are added to the basis of the property and are determined to be reasonable and related to the services performed.

**Recapture** – The property owner must retain ownership and retain the historic integrity of the building for five years after rehabilitation or pay back the credit. The amount to be paid back is reduced 20% for each full year of ownership.

**Rehabilitation** – The process of returning a property to a state of utility through repair or alteration which makes feasible an efficient contemporary use while preserving those features of a property which are significant to its historical, architectural, and cultural values.

**Substantial rehabilitation** – A federal rehabilitation tax credit requirement that dictates that in order to earn the credit, rehabilitation expenditures must exceed the greater of $5,000 or the adjusted basis of the building and its structural components.

**Tax credit** – A tax benefit that directly reduces the amount of taxes owed.

**Tax credit equity** – Cash provided to a property owner in exchange for the right to receive the federal rehabilitation tax credits.

**Tax deduction** – A tax benefit that reduces the amount of income subject to taxation.

**Transferable tax credit** – A tax credit that can be freely sold, transferred, or assigned to another individual or entity at the discretion of the holder of the credit.

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